

EFFECTIVE CRISIS MANAGEMENT FOR ISLAMIC FINANCIAL INDUSTRY AND THE INSTITUTION OF *HISBAH*: LESSONS FROM GLOBAL FINANCIAL CRISIS

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ABSTRACT - The recent financial crisis resulted destructive effects on finance industry. Islamic financial industry (IFI) is still naïve and largely untested in the face of a major financial turmoil. Major issues and uncertainties of the insolvency of IFI include the issue of moral hazard, government bailouts, excessive risk taking and deposit insurance. This paper addresses the issue of crisis management in IFI from the perspective of al-Siyasah al-Shar'iyyah and attempt to derive public policy guidelines that are useful in developing a timely and efficient crises management framework for Islamic finance industry. By using qualitative methods, the study found that the global financial crisis resulted in great destruction of financial institution. Although Islamic finance was quite immune to the global crisis as compared to its conventional peer, concerns still exist. It is time that Islamic finance industry learns from the financial woes of the rest of the world.

Key Words: Islamic Law, Global Financial Crisis, Public Policy, Sadd al-Dharai'

ABSTRAK - Krisis keuangan baru-baru ini mengakibatkan efek destruktif pada industri keuangan. Industri keuangan Islam (IKI) masih naif dan sebagian besar belum teruji dalam menghadapi gejolak keuangan besar. Isu utama dan ketidakpastian dari kebangkrutan IKI meliputi moral hazard, dana talangan pemerintah, pengambilan risiko yang berlebihan dan asuransi deposito. Makalah ini membahas isu manajemen krisis dalam IKI dari perspektif al-Siyasah al-Shar'iyyah dan berusaha mendapatkan pedoman kebijakan publik yang bermanfaat dalam mengembangkan kerangka kerja manajemen krisis yang tepat waktu dan efisien bagi IKI. Dengan menggunakan metode kualitatif, studi ini menemukan bahwa krisis keuangan global mengakibatkan kehancuran besar bagi industri keuangan. Meskipun keuangan Islam cukup kebal terhadap krisis global dibandingkan dengan keuangan konvensional, kekhawatiran masih ada. Sudah saatnya industri keuangan Islam belajar dari krisis keuangan dari seluruh dunia.

Kata Kunci: Hukum Islam, Krisis Keuangan Global, Kebijakan Publik dan Sadd al-Dharai'



INTRODUCTION

Whether inspired by the sincere desire to fulfill the religious obligations of the Muslim population or an ingenious marketing tactic, Islamic finance has successfully emerged as a viable alternative or, at minimum, a complement to conventional finance. Regardless of its true intention in inception, the development of Islamic finance is crucial indeed. It evidences the fact that there is no separation between spiritual and mundane in Islam. The Shariah, i.e. Islamic Law, is a code of conduct that, apart from its catering for the spiritual needs, encompasses all social, political, legal, and economic aspects of the Muslims' lives. Hence, they are required to adhere to the Shariah commands in their economic endeavors, which include, but are not limited to, refraining from the major prohibited activities of *riba* (interest), *gharar* (grave uncertainty), *maysir* (high speculation), and *jahl* (ignorance). Profit and loss sharing, profit based on readiness to take risk, and all transactions backed by an asset are also among the unanimously accepted features of Islamic finance.

Although Islamic banks have come out of the sub-prime and credit crunch in better shape than many of their conventional counterparts, banks do fail from time to time, and eventually an Islamic bank will too. This prospect raises some important issues because the bulk of Islamic banking is a voyage into the realm of unknown, including the consequences of a downfall. However, the recent financial crisis has brought this issue to the full front. As country after country in the advance economy was hit by it, the stakeholders in Islamic finance were automatically alarmed about any such scenario faced by Islamic finance in the near future. There are many questions that need to be answered. At the front of these questions is the possible response of the regulator in times of such crisis. Since Islamic finance is concerned with Shariah compliance, this kind of compliance has to be maintained in times of policy making and policy decision related to crisis management.

However, since Islamic finance has thus far been safe from any severe crisis, there is a lack of certainty as to how would such a crisis be managed in the future. But conventional financial system has been through many such crises; it has learnt some good lessons from its past experiences and has forgotten many others. Thus, Islamic finance has the chance to benefit from all the good that can be offered by conventional and avoid what had made conventional finance suffer most. The objective of this paper is to draw such lesson as a roadmap for Islamic finance in terms of effective crises management. In addition, it is argued that one classical Islamic institution known as *al-hisbah* can also help



in making Islamic finance well prepared for any disastrous situation in the future.

In detail the objective of the paper are: (1) To determine the most important facts and episodes of global financial crisis, (2) To highlight the causes of the crisis and the factors responsible on it, (3) To see the interconnectedness of *al-hisbah* with crisis related regulations in Islamic finance, (4) To suggest how Islamic finance can handle better with such situation in the future and (5) To recommend future directions to the policy makers.

The structure of this paper consists of three section. Section one discusses the global financial crisis in 2007-2008. The causes and consequences as well as the damages of this event are briefly highlighted. The next section is an overview of the classical Islamic institution of *al-hisbah* and its connectedness and importance in the sphere of finance and business. This section briefly introduces the principles of *sadd al-dharai*, *masalihmursalah*, and legal maxims of Shariah. Section three outlines the important lessons that can be learnt by Islamic finance from the global financial crisis. These lessons can help regulators and policy makers adopt the most suitable approach to crisis management. The paper ends with a brief conclusion.

METHODOLOGY OF THE STUDY

In line with these objectives, the study follows qualitative methodology of research which suits the nature of the topic. There is no quantitative data required for it since the directive and objective is to help in policy and decision making. The relevant literature to global financial crisis is analyzed and the most important lessons, causes and future course of action are detected. The institution of *al-hisbah* is also explored as it matches regulatory and public policy essence. On the basis of these facts, the possible public policy direction for Islamic finance is arrived at.

DISCUSSION

BACKGROUND TO GLOBAL FINANCIAL CRISIS

Literature has sufficiently analyzed the panicky financial episodes of the past; but the bulk of it is related to the global financial crisis in 2007-2008 which has analyzed almost each aspect of it. The stage for financial crisis was set by large complex financial institutions (LCFIs) through “(1) originating high risk loans... and (2) pooling these loans to create securities that could be sold to



investors” (Wilmarth, 2011). But this was not the end of the story; “with the blessing of regulators”, LCFIs were allowed securitization through which they reduced their apparent risk and, consequently, lower their capital requirements by creating structured finance securities. These securities consisted of a variety of products matching the demand of customers according to their risk and return appetite, including: asset backed securities (ABS), residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS). This was the first level of securitization which was followed by the second layer of securitization including: collateralized debt obligations (CDOs) and (corporate) leveraged buyouts (LBOs). There was a third layer of securitization in the form of “CDOs-squared”. The risk of securitization was intensified through over the counter (OTC) credit derivatives called credit default swaps (CDS) which was equal to insurance in the event of default. The financial system’s risk exposure was further enhanced through synthetic CDOs (Wilmarth, 2011).

According to an estimate by IMF, private-sector financial institutions issued about \$15 trillion of ABS, MBS, and CDOs in global markets between 2000 and 2007, including \$9 trillion issued in the United States and, as per a second study, \$11 trillion of structured-finance securities were outstanding in the U.S. market in 2008 (Wilmarth, 2011). This sway of securitization motivated lenders to provide more credit to the borrowers without looking into their credit history (Leicht & Fitzgerald, 2007). What added to the gravity of the situation was the government’s decision not to regulate the securities’ market. However, concerns were raised regarding the substantial risk that was involved in securities and which was difficult to evaluate. The financial crisis was born from the gradual development of institutions that encouraged opportunities for risk taking without enough institutional checks against such behavior (J. L. Campbell, 2011). Nevertheless, the champions of deregulation dominated the scene and even if efforts were made to control the situation, they were to no avail.

However, once there was a decline in the housing prices starting from late 2006 as a result of subprime mortgages, customers began to default on their loans and the effect spread across the finance industry. Large mortgage companies in US like Fannie Mae and Freddie Mac were taken by government. The collateral damage caused by both mortgage backed and asset-backed securities was unprecedented. The bankruptcy of Lehman Brother added fuel to the fire. Among the great giants that succumbed or almost succumbed to this situation was American International Group which almost collapsed. Since its



failure would cause other institutions fall, the government provided an \$85 billion loan in exchange for a 79.9% equity stake in the company—a bailout that eventually totaled \$182 billion by March 2009 (J. L. Campbell, 2011).

Financial Liberalization

An important episode before the global financial crisis was a sway of deregulation of the market and one of the most important changes before the financial crisis was the repeal of the Glass-Steagall Act of 1933 which was introduced then to mitigate opportunism as well as excessive risk taking by the banking industry. These two were the considered the causes of the Great Depression. However, it was replaced by the Financial Services Modernization Act- a politically driven legislation- in 1999 in order to enable banks to compete efficiently in the international market (Stiglitz, 2003). This act freed many markets from the regulation of government. Especially, it terminated regulatory oversight from credit default swap which had a market of \$60 trillion world-wide by late 2008 (Morgan, 2008).

Financial services mergers occurred at a massive scale (J. L. Campbell, 2011) and ultimately “shadow banking system” grew rapidly. This banking system did not accept deposits like commercial banks do. Therefore, they were not bound by the same safety regulations as other traditional banks were, like the requirement for capitalization (Wolf, 2009). Further deregulation followed in 2004 when capital requirements were further eased, making credit availability much easy. It was allowed now to shift capital from safer to riskier and more profitable investments. Previously, a fixed percentage of each dollar of capital had to be reserved by securities’ firms to ensure safeguard in case of collapse. However, now these firms were allowed to use non-cash assets like asset-backed securities to avoid this risk. This made more money available for use as collateral to borrow money. The leverage ratio before this change was 12-1 which reached a peak of 33-1 after this change in policy (Blinder, 2009). Several other reforms in securities markets assisted each other to create further incentives for more risky investment behavior. All this meant that that credit flowed easily and excessively than before especially to the housing market. The opponents of regulations succeeded in their argument that they hinder the efficiency of these new and lucrative markets (J. L. Campbell, 2011).

The availability and ease of loans is indeed the tool which was utilized and which led to the gloomy financial landscape of 2007-2008. This was made possible due to the financial innovation which was much boosted upon before the crisis but which was nothing more than a second name for issuing more and



more debt. As John Kenneth Galbraith expresses it: “financial innovation is simply another way to issue debt” (Samwick, 2009). In the case Northern Rock bank of UK, the result of this financial innovation was that customers could borrow 125 percent of their property value and up to six times their annual income: the boring days when customers could borrow only 75 percent of their property value and a maximum of three times their income were over (Dowd, 2009).

The modern risk management tools and practices used by risk management practitioners are based on unreal assumptions: “they assume that financial risks follow Gaussian distributions (and so ignore the “fat tails” which really matter); they assume that correlations are constant (and ignore the fact that correlations tend to radicalize in crises and so destroy the portfolio diversification on which a risk management strategy might be predicated) and they make assumptions about market liquidity that break down when they are most needed (Dowd, 2009). Accordingly, the risk involved in the era of financial innovation were hidden, or even misunderstood until it was late to return and fix the matters.

Taleb (2010) blames the unrealistic theories, models and tools used by the economic establishment cheatingly. He said that it is surprisingly the economics establishment should have been aware of the use the wrong tools and complete fiasco in the theories, but they kept pushing the warnings under the rug, or hiding their responses. The inadequacy of economic theories to explain the causes of run is expressed by Ayotte (2009) that economic theories can explain the consequences of panic runs when they occur, but they do not explain what triggers them in the first place. The dangers of macroeconomic models are explained by Leijonhufvud (2014) that macromodels that ignore problems of instability are dangerous to the health and welfare of untold millions of people. The same writers further hints towards the inadequacy of another model by concluding that my personal conclusion is that Walrasian equilibrium models are hopelessly inadequate for dealing with financial crises and their aftermaths.

To conclude, there were numerous factors responsible for the downfall of economies in 2007-2008. The factors responsible for crisis include regulators, corporate governance and risk management, excessive borrowing, government failure, ethical failure, mortgage-lending and securitization, derivatives and rating agencies. However, if there was one factor generating all these sources of failure, it was ‘moral hazard’ alone. A moral hazard is where one party is responsible for the interests of another, but has an incentive to put his or her



own interests first: the standard example is a worker with an incentive to shirk on the job (Dowd, 2009). The principal incentive problem is moral hazard. Moral hazard is the familiar concern that someone who is protected against the consequences of a risk has less incentive to take precautions against the risk (Ayotte & Skeel., 2009). Moral hazard in finance world can take place in many shapes such as a person may sell another person a financial product, like a mortgage, with the knowledge that it is against the interest of the buyer. He may pay himself huge bonuses from the funds that he manages on behalf of others. He may take risks the consequences of which are born by others.

According to Dowd (2009), the most fundamental reason for the failure of risk management is economic in nature, there is strong incentive to take risk which leads to risk taking ultimately. In such scenario, risk management is like “war on drugs” which helps curing the disease but it can never win conclusively. No matter how prudent risk managers are, they are prone to orders from senior management, pressurized to take short cuts, produce lower risk number to decrease capital requirements and are, thus, not willing to rock the boat. In addition, if senior management itself is fed on remuneration package that induce excessive risk-taking, the result is not difficult to guess.

As elaborated above, it is moral hazard that laid at the foundation of all that happened before and during the financial crisis are: excessive risk taking, debt creation in the name of financial engineering, multi-layers of securitization, financial liberalization and deregulation and billions of bailouts and assistance from the taxpayers’ money. However, the question worth pondering is that what causes this moral hazard which is the root of all problems in this case? According to Dowd (2009) The root problem is limited liability, which allows investors and executives the full upside benefit of their risk-taking, while limiting their downside exposure. Since modern corporations are founded on the notion of legal personality and limited liability, the parties involved in the financial market are aware of the mechanism of reaping its fruit. Campbell and Griffin (2006) said that rightly opine on this situation that one has to stretch the point to say that the executives of large public companies are exposed to the economic risks of failure in any significant way, and certainly they are more or less completely cocooned from the most fundamental market pressure, fear of personal bankruptcy.

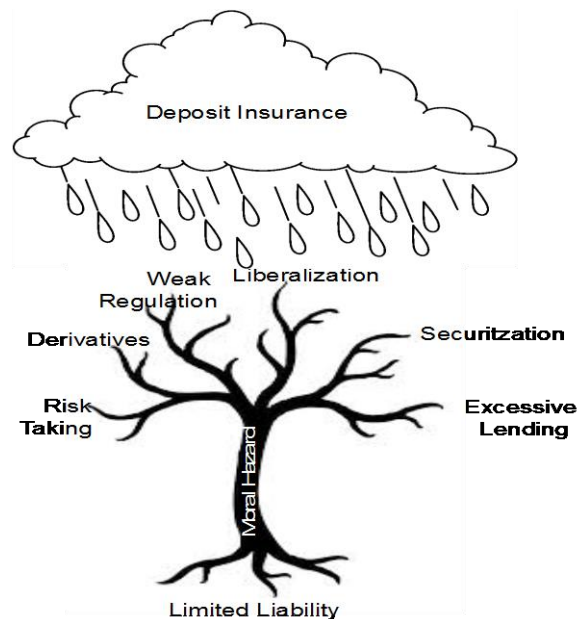
The root of the problem of limited liability is highlighted by Ho and Price (2011:25) in these words, the surprisingly tenacious mythology in *Salomon v Salomon*, that a company is a separate person whose liabilities are not necessarily shouldered by its proprietors, while promoting investment in



situations where there might be none, is also the prime cause of moral hazard in the global financial system. However, what the writers attribute here to limited liability is sensed long ago by Adam Smith when he criticized corporations.

What the writers mentioned above argue about can be summarized with the help of a simple tree diagram as below:

Diagram 1. An Anatomy of the Global Financial Crises



The diagram is clear in essence. Although the sequencing may be changed if viewed from a different perspective, it is generally agreed that the problem starts when liability of parties involved in any transaction or market is limited. It directly leads to the issue of moral hazard that is further exhibited in different forms or branches. However, on the tops of all is the issue of deposit insurance. Ample of literature has elaborated how moral hazard is magnified by deposit insurance. It has been argued that financial institutions, especially banks, have unique prudential regulations like explicit insurance deposit guarantees. Whereas these guarantees are to make sure the stability of the system and avoid bank runs, they induce moral hazard problem in ex ante sense, i.e. before the failure of bank. Due to such implicit guarantee by governments, moral hazard is also created in the ex post sense after the banks have become or near to insolvency (Marinc & Vlahu, 2012). It hardly needs any argument that it is deposit insurance that makes depositors indifferent towards the performance and stability of the banks, since they are sure of the safety of their deposits. In addition, banks are also induced to take as much risk

as they can in order to increase value for their shareholders and ensure their personal bonuses etc. Indeed, deposit insurance is one of the major reasons that contributed to the collapse in 2007-2008.

ISLAMIC PERSPECTIVE ON CRISIS MANAGEMENT: *HISBAH*, *MASALIH*MURASALAH AND *SADD AL-DHARAI*

Market Regulation in the Earliest Islamic Era

Even though small and simple, market was regulated in the early Islamic period by the Prophet peace be upon him and the four pious Caliphs, may Allah be pleased with them all. Numerous instances can be quoted in this regard. Theoretically, the Prophet peace be upon him stressed “individual” accountability in these words: “Beware that every one of you is a shepherd and everyone is answerable with regard to his folk. The caliph is a shepherd over the people and shall be questioned about them. A woman is a guardian over the house hold of her husband and his children and has to be questioned about them. A slave is a shepherd over the property of his master and shall be questioned about it”. Then he, may peace be upon him, adds: “beware that every one of you is a guardian and every one of you shall be questioned with regard to his trust”. The words of this *hadith* explicitly make each individual responsible for his/her subordinates. Thus, it is a manifestation of both individual and “institutional” or “organizational” responsibility in which those in charge of some task or some persons are responsible for their duties towards them accordingly.

Dost (undated) argues that the institution of “*hisbah*” that is to be found in the later Islamic era was inspired by the practice of the Prophet peace be upon him, as he used to visit the market personally and check on the accuracy of measures. The Prophet also assigned specific places to different mongers and prohibited different market practices like meeting the producer-farmer at the entrance of the city before they reached the market, fearing they may sell at lower price. The Prophet peace be upon him was also opposed to price fixation at the time of scarcity when he replied those who complained high prices and requested to fix it: “the seller and the buyer, the one who provides and who fixes the prices are nobody but the God. I don’t wish to die whilst people having demands of life and property from me”.

This conduct of the Prophet peace be upon him was taken as a role model and followed by the four Caliphs after him. In this regard, the first Caliph of Islam, Abu Bakkar, may Allah be pleased with him used to keep a check on his



collectors when they leave for their task or return from it. Thus, he asked Muaz ibn Jabal may Allah be pleased with him, to give account of what he had done. He replied, are we subject to two accounts, one towards Allah and the other towards you? However, he did as he was directed by the Caliph. Usmani (Usmani, 1414 H) narrates an incident of the practical supervision of Umar may Allah be pleased with him. Once he was on a visit to the market where he found that a person was selling something at a lower than the market price. Watching this, he ordered that person: "Either you increase in price, or go away from our market." It has also been narrated that it was the habit of Umar may Allah be pleased with him to patrol in the market of Medina with his *durrah* in his hand and would guide those who needed correction (Shahatah, 1999).

What the above instances show is that keeping a proper check and balance on the market of that time was considered an important task by the Prophet and his followers. Their personal interest in the issue reveal that disciplining the prevalent business practices of their respective time, though these may be of a small scale, held serious importance in their opinion. This consequently led to the establishment of the institution of *hisbah* in the Islamic realm. This institution and position of *muhtasib* will be discussed below.

The Institution of *Hisbah* and Duties of *Muhtasib*

Keeping in view the aforementioned examples from the earliest Islamic era, a separate institution for market supervision was established later which was called *hisbah*. This institution was formed based on the Islamic concept of "*al amr bil maroof wal nahyu anil munkar*" i.e. (the task of) enjoining what is right and forbidding what is evil. This is an essential feature of a given Islamic society and Quran stresses upon the establishment of this institution, either by the state or by the community members themselves. In fact Quran declares this task to be the sole purpose and duty of the Muslim Ummah: "You are the best Ummah ever raised for mankind. You bid the Fair and forbid the Unfair, and you believe in Allah." Based on these Quranic injunctions, *hisbah* has been defined as a religious institution under the authority of the state that appoint people to carry out the responsibility of enjoining what is right, whenever people start to neglect it and forbidding what is wrong, whenever people start to engage in it (Yaacob & Donglah, 2012). This definition is broader enough to include both financial and non-financial obligation of a *muhtasib*, the person in charge of performing this duty.



In its strict financial and business sense, the duty of *muhtasib* was to ensure that the daily business transactions are done in a manner that is not harming the society (Rahim & al, 2012). The major responsibility of *muhtasib* was to ensure that the business practices prevalent in the market are in accordance with Islamic injunctions and each party is getting its due rights as well as performing its duties. It is not an exaggeration to state that the current day “regulator” has the same task to perform as was done by the classical *muhtasib*, although a regulators role is restricted to the extent of monitoring that everything in the financial markets is according to the regulations whereas *muhtasib* concentrated on the physical inspection of the market. This change is the direct outcome of the changes that have taken place in the business structure during the course of the centuries.

The classical Muslim writer, Al-Mawardi (450 AH), has elaborated the duties of *muhtasib* in his famous book *al-Ahkam al-Sultaniyya*. In fact he has devoted a full chapter of his book for this purpose which he titled as *al-hisbah*. The writer starts with outlining in detail the nine differences between a *muhtasib* and a person who performs the task of “enjoining the good and forbidding evil.” Regarding the conditions of *muhtasib*, Al-Mawardi (450 AH) opines that he should be free, just, of sound judgment, firm in religion, and be aware of what evil is.. He then elaborates how this institution lies in between two other institutions: the judiciary and the court of grievances. This is followed by a detailed description of the duties of *muhtasib* which the writer categorizes into two broader categories first: commanding the good and forbidding the evil. Commanding the good is further classified by him into three types and forbidding the evil into three types alike, each with its detailed rulings and ample examples.

A *muhtasib* would hear cases related to different aspects. However, the financial matters dealt by him included: (1) Weights and measures, (2) Adulteration, (3) Supervision of certain sensitive professions and (4) Checking public places for proper maintenance or removing obstructions in the market (Niazi, 1991). Some duties that the writer assigns to the *muhtasib* include the prevention of contract or practices that is totally prohibited by Shariah, e.g. usury etc. He must also denounce any fraudulent practices in the market that harm any of the bargaining parties. Of supreme importance is the duty of *muhtasib* is to prevent the practice of giving short measures. To do this, he should test and control the market weights and measures appropriately and may even use a stamp of his own to ensure a single standard practice in the whole market. Al-Mawardi (450 AH) argues that if the jurisdiction of inspection is



large enough, the *muhtasib* can even appoint inspectors of investigation who would help him in performing his duty. These inspectors must be trustworthy person, should be paid from the *Bait al-Maal* and be immediately dismissed if it is known that they are involved in any malpractice themselves.

Thus, it can be concluded that accountability in general and financial accountability in particular has held great importance in both Islamic literature and the practice of Islamic state at the time of its inception. Whereas the two major sources of Islamic Shariah, namely Quran and Sunnah, provided a general framework as well as theoretical foundation for financial accountability, it was practically demonstrated by the Prophet peace be upon him and his followers since the early Islamic era. Both these steps led to the establishment of the institution of *hisbah* or market supervision in the later years. The rulings about *hisbah* and the duties of *muhtasib*, the market supervisor, were elaborated by Muslim jurists and scholars as we have seen Al-Mawardi (450 AH) as an example of it. This shows the deep concern of Islam with what can be termed in today's world as "market regulation". However, we have also observed that regulation in Islamic terminology is wider than its meaning in conventional term; the former encompassing one's actions, thoughts, and even intentions.

In his case study, Stilt (2008) reviews the application of law by *muhtasib* in the era of Mamaleek and arrives at some interesting conclusions. He defines *muhtasib* as: "an inspector of the markets and public spaces in general, was a legal official charged with "commanding right and forbidding wrong," and was tasked with patrolling public streets, especially in the marketplaces, and enforcing laws as he understood them whenever he encountered a violation. According to the writer the general population also associated the *muhtasib* with availability and cost of food and "when prices rose and food was unavailable, the people often held the *muhtasib* responsible. In one important instance, Stilt (2008) shows how the higher authorities have to intervene in the market if the calamity is big enough.

This was a large-scale crisis, encompassing both major cities and requiring grain to be brought from other parts of the sultanate, so it is not surprising that the price setting came down from the highest level. An important conclusion one can draw from this case study is that the rulings in *fiqh* may change according to circumstances of the people and their sufferings in a specific period. In other words, the law was applied in the context of different factors working from behind the screen. Thus, the writer firmly concludes that we can see that the *muhtasib's* actions resulted from a combination of social,



economic, and political factors; the potentially applicable laws; and the particular personality of the *muhtasib*. In a nutshell, the institution of *hisbah* has played a vital role in the past in the Muslim societies especially in the economic domain. This institution was effective in dealing with the crises' situations and people looked at it in times of food scarcity and other times of distress.

Masalih Mursalah

Maslaha in simple terms means the benefit that Shariah has given consideration for the sake of people's interest. One specific type of *maslaha* is where Shariah has left a specific matter to be decided by people according to their best interest and in line with Shariah guidelines; this type of *maslaha* is called *maslahamursalah*. Famous examples include the compilation of Quran and the order of taking qisas from a group of people for the murder of a single person (Al-Aamidi, 1983). There is no doubt that the bulk of modern day financial matters can fall under the category of *maslahamursalah* unless they do not violate the spirit of Shariah. The very existence of financial institutions like banks etc constitutes great interest for the masses. Therefore, their existence is justified on the basis of public interest even if they are not directly found in or derived from the sources of Shariah.

In the context of crisis management, one can see the potential role that might be played by *maslaha*, especially when it is coupled with the legal maxims of Shariah. Consider, for instance, the case of deposit insurance or bailouts for financial institutions in times of crisis. Based on the notion of public interest, it is, at least apparently, in the best interest of masses at large to be protected through such mechanisms. Hence, providing these facilities for the sake of public confidence and their fund protection seems in line with the notion of *maslaha*. However, there is another angle of this too. As reviewed in the first section of this paper, deposit insurance and government bailouts lead to moral hazard as well. They can induce bankers take risks beyond their capacity and then make the general masses or taxpayers pay for it. To solve this issue, one needs to turn towards legal maxims for guidance. One of the maxims in this regard states that: averting harm takes precedence over achieving benefit (Laldin & al, 2013). With Looked at in a combination with these types of legal maxims, the important lesson from the global financial crisis seems to be that the issues of deposit insurance and governments' bailouts needs careful deliberation. This is due to the fact that *maslaha* does not exist on the positive side only; on the other side, it is the second name for averting and avoiding the harm too.



Sadd al-Dharai

One unique feature of Islamic law is that it is proactive in nature; it takes precautionary measures to stop a bad or evil from happening. Unlike other legal systems where such mechanism may not necessarily be found, Islamic law uproots the evil from the scratch and blocks its way from the beginning. Take the example of fornication or *zina*. Islam has prohibited this act and has also banned the ways that might lead to the commitment of this act, like free mixing up of the two genders and other practices that might ultimately lead to fornication. In fact Islamic law has gone one step further by disallowing acts that might even be permissible in the first place but they might lead to an evil or impermissible result in the long run. This notion is technically known as *sadd al-dharai* or simple blocking the permissible means to prevent unlawful things. One example given by scholars is selling weapons to people at the time of *fitnah* or selling wine to someone who is known to be manufacturing from it (al-Zuhaily, 1986).

In contrast to the notion of *maslaha* or benefit, *sadd al-dharai* can be utilized as a handy tool for policy making in crisis management by not allowing something the result of which are known to be detrimental in the long run. This is especially true in the context of the global financial crisis. As explained in section 1, excessive lending led to credit boom which later on turned into one of the worst financial woes for humanity. Based on the principle of *sadd al-dharai*, policy makers in Islamic finance need to have an eye on this principle while deciding and mapping for the long run. If credit creation is allowed for Islamic banks, should there be a limit for it or not? Similar questions can be asked about derivatives too. No doubt that the existence of moral hazard will definitely hamper any reactive measures when times are bad. Therefore, *sadd al-dharai* has to be utilized as a proactive measure in Islamic finance policy making.

RECOMMENDATIONS FOR POLICY FORMATION IN ISLAMIC FINANCE

The discussion in above two sections leads to a few conclusions that can be put into suggestions and recommendation for regulators and policy makers in Islamic finance. However, it can be seen that the following points are not clearly distinguishable and all of them are closely interconnected. The reason to put them separate is to show that they are individually important in terms of crisis management and need special focus of the policy makers.



Excessive Debt Creation

It was seen above that excessive lending was the founding step towards the financial destruction in 2008. It was in the form of securitization and derivatives etc. However, Islamic commercial law has a unique mechanism to deal with this issue. This mechanism consists of not only reactive measures but is also proactive in nature. In the first place, Islam wants debt not to be taken except in the case of real need. Secondly, there is a security measure in the form of *rahn* to ensure safe repayment of debt created. The third layer is that of insolvency law which further restricts the options of escape or avoidance of debt obligations. In fact the uniqueness of Islamic stance on the issue of debt can be easily understood from the fact that the longest verse of the Holy Quran deals with securing debt.

Lastly, non-payment of debt is announced as one of the gravest sins, making the borrower morally and religiously obliged to pay it at any cost. Thus, these layers after layers provide a natural safety mechanism against excessive risk taking that was evident in global financial crisis. The above facts and the West's experience with debt during the global financial crisis should be an indication for Islamic finance policy makers to reconsider issues like fractional banking reserve system that sometimes makes debt creation possible to unlimited extent. It also calls for an insolvency regime that clearly distinguished the rights and obligations of the parties to financial markets in the case of insolvency, bankruptcy and financial distress. Such a regime, however, is missing currently and it is not clear what will happen in case the Islamic finance industry faces a crisis at mass level.

Legal Personality and Limited Liability

As explained above, it is the modern principle of limited liability that lays at the heart of this whole debate since this principle leads to all other moral hazard problems. Once again, Islam has addressed the issue explicitly, for instance, in the form of legal maxims like: "Benefit goes with liability and Liability accompanies gain" (Laldin & al, 2013). Apparently, the maxims indicate the liability cannot be limited if the gain is unlimited. This is also asserted by Usmani who accepted the notion of legal personality and limited liability for large public corporations only due to necessity. However, many of the contemporary scholars defend the acceptance of these principles on different grounds that sound reasonable.



But one cannot forget the role played by moral hazard during the crisis which was the direct outcome of limiting liability. It was elaborated above that legal personality and limited liability have been questioned in the West since the time of Adam Smith. It is also accepted that both these principles are required for modern day corporations to work. But it does not mean that precautionary steps are not available to solve, or at least minimize, the negative impact of these. Consider some suggestions by Schluter (2000) to address this issue. Firstly, the shareholders may be made liable for ten percent of the company's debt if insolvency happens. Under this principle, the shareholders would be liable according to their respective shares in the company and not according to their personal wealth; i.e. the largest and not the wealthiest should be liable. Secondly, company law could also be changed to move away from this principle.

Risk Taking and Moral Hazard

If risk is taken with the knowledge that its consequences will be born by other parties, it has no limits as its destruction can be unlimited. Many of these moral hazards involve increased risk-taking: if I can take risks that you have to bear, then I may as well take them; but if I have to bear the consequences of my own risky actions, I will act more responsibly. Thus, inadequate control of moral hazards often leads to socially excessive risk-taking and excessive risk-taking is certainly a recurring theme in the current financial crisis (Dowd, 2009).

Risk taking can come in numerous forms and risk that is natural to the business and finance environment is acceptable, rather essential, to be taken and even mitigated. But risk creation in the form of toxic instruments is highly questionable. These toxic instruments may produce good results in the short-run, but their long term damaging effect is visible even today after years of the global financial crisis. Considering the legal maxim, averting harm takes precedence over achieving benefit (Laldin & al, 2013), toxic risky instruments need to be reconsidered. Shariah compliant derivatives etc. need to be scrutinized and controlled before they turn into something uncontrollable. Perhaps the small harm caused by the absence of these instruments is far better than the damages it caused during the global financial crisis.

It is only a matter of time to realize it. An excellent example of risk taking is provided by Al-Mawardi (450 AH) states that the *muhtasib* must prevent ship-owners from carrying a load which exceeds the capacity of the ship, lest it should lead to its sinking; likewise, he should stop them sailing when strong winds are blowing. The writer understood that the ship owners, in their quest



for more profit, may put the money of other people at stake and, therefore, it is the responsibility of *muhtasib*, the regulator, to control such behavior.

Governments' Bailouts

Government bailout to the troubled institutions is a very serious issue in crisis management. It is often argued that bailing out large financial institutions in crises is something not avoidable; if not provided, the whole system can collapse. However, this may not be the case and it is sometimes wise not to make taxpayer suffer for the sake of too big to fail. Ayotte and Skeel (2009) provide the example Lehman Brothers collapse and AIG bailout to prove that bailing out and letting fall may produce the same results which shows that insolvency is not always a bad option.

Table 1. Comparative Statistics Index between Lehman Brother and AIG

Index	Lehman Brothers			AIG		
	12 Sep	15 Sep	Change	16 Sep	17 Sep	Change
S&P 500	1251.7	1192.7	-4.71%	1213.6	1156.39	-4.71%
Volatility (VIX)	25.66	31.7	23.54%	30.3	36.22	19.54%
TED Spread	1.35	2.01	0.66	2.19	3.02	0.84
13-weeks treasury bill	1.46	0.81	-0.65	0.86	0.02	-0.84

Source: Ayotte and Skeel (2009).

What is demonstrated from these numbers is that contrary to the expectations from AIG bailouts, the response from the market was not so positive. On the one hand, this shows how if the confidence is lost, it is difficult to restore it especially in times of crisis. On the other hand, it is evident that bankruptcy has to be kept open as an option in times of need.

Deposit Insurance

It is suggested that the policy makers in Islamic finance should reconsider the deposit insurance. It is the root cause of moral hazard in conventional finance and has been questioned in conventional finance too. If the investors who fund a financial institution by lending money or buying stock anticipate that the firm will be rescued if it runs into trouble, they may extend funding beyond what they would extend otherwise (Ayotte and Skeel, 2009). It has also been argued that deposit insurance strongly affect market discipline negatively by making depositors indifferent towards the performance of banks. Consequently, banks



are induced to take risk that is not suitable at all; the depositors will not bother the banks' risk taking as long as they are sure about their deposits.

Even if not abolished, its mechanism should be such that moral hazard is avoided as much as possible. One suggestion given in the wake of recent crisis is that deposit insurance should be dependent on two factors: the size of the financial institution and the risk it takes. These steps will make financial institutions make responsive towards this issue and make less risky investment, i.e. risk that they can pay for first.

CONCLUSIONS AND RECOMMENDATIONS

The global financial crisis resulted in great destruction and the world has not yet recovered from it. It is not known how much time it takes the finance world to stand back on its feet again after the collapse. However, there is something positive that the crisis gave the world; it is the regulatory and policy lessons that can be derived from it. Although Islamic finance was quite immune to the global crisis as compared to its conventional peer, concerns still exist. It is time that Islamic finance industry learns from the financial woes of the rest of the world. In fact the world is already changing its financial landscape with heavy reforms and stricter regulations like the new Basel requirements etc. However, the policy makers of Islamic finance should understand that it is one thing to fight against evil; it is absolutely different to curb the very roots of the evil.

The West may succeed in its struggle but its success will be temporary only. If crisis management policy for Islamic finance is based on the principles elaborated in this paper like *hisbah*, *maslaha*, and *sadd al-dhariah*, it is hoped that the solutions will be everlasting. In line with the nature of Islamic law in general, such a policy has to be proactive and address the relevant issues before they occur, instead of being reactive and just wait for a crisis in Islamic finance industry to happen first and then think of solutions. It is time for the industry and the policy makers of Islamic finance to revisit their existing strategies and come up with solutions that comply with the spirit of Shariah and can become a role model for the rest of the world.

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